

***United States Court of Appeals
for the Second Circuit***



AMICUS BRIEF

77-6034

IN THE
United States Court of Appeals
FOR THE SECOND CIRCUIT

Docket Nos.
77-6034, 77-6038, 77-6040, 77-6045, 77-6048, 77-6065

IN THE MATTER OF
WEIS SECURITIES, INC.,

Debtor.

GEORGE D. ALDRICH, ET AL.,
Claimants-Appellants,

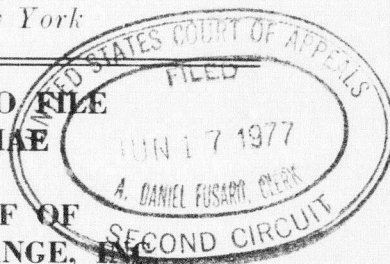
v.

EDWARD S. REDINGTON, Trustee, and
SECURITIES INVESTOR PROTECTION
CORPORATION,

Appellees.

*Appeal from the United States District Court for the
Southern District of New York*

**MOTION FOR LEAVE TO FILE
BRIEF AMICUS CURIAE
AND
AMICUS CURIAE BRIEF OF
NEW YORK STOCK EXCHANGE, INC.**



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**MOTION FOR LEAVE TO FILE BRIEF
AMICUS CURIAE OF
THE NEW YORK STOCK EXCHANGE, INC.**

The New York Stock Exchange, Inc. respectfully moves, under Rule 29 of the rules of this Court, for leave to file a brief *amicus curiae* in support of the opinion and order of Judge Inzer B. Wyatt dated January 20, 1977, confirming the Trustee's position with respect to claims of subordinated lenders.

The Exchange is, and has been since October 1, 1934, registered as a national securities exchange with the Securities and Exchange Commission pursuant to the Securities Exchange Act of 1934. As of October 31, 1972, the Exchange had 366 members, many of whom are associated with 579 organizations (either partnerships or corporations, hereinafter "member organizations") engaged in the securities business.

Under section 6 of the Exchange Act, the Exchange is charged with, among other things, enforcing compliance with its rules to protect investors. The cornerstone of the Exchange's rules and regulations designed to maintain such financial responsibility by member organizations of the Exchange is Rule 325, the net capital rule, under which capital made available pursuant to a satisfactory subordination agreement plays a vital part.

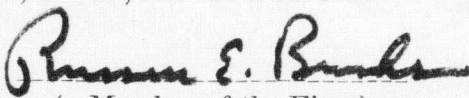
Twenty-three subordinated lenders to Weis Securities, Inc. (the "Debtor") claim that their subordination agreements with the Debtor, a former member organization of the Exchange being liquidated under the Securities Investor Protection Act of 1970, should be rescinded on the ground of fraud. These subordinated lenders seek to share in the Debtor's general estate on a parity with, and in some cases in priority to, general creditors, including customers and subrogees, particularly the Securities Investor Protection Corporation. Resolution of this issue will have an im-

portant effect on the Exchange's regulatory responsibilities in respect to the financial structure of member organizations.

For the foregoing reasons, the Exchange respectfully requests leave to appear *amicus curiae*, for the purpose of filing the attached brief.

Respectfully submitted,

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June 10, 1977

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Appellees.

**AMICUS CURIAE BRIEF OF
NEW YORK STOCK EXCHANGE, INC.**

STATEMENT OF THE ISSUES

The issues on this appeal are:

1. Whether an investor in a broker-dealer who expressly subordinates his claims to the claims of general creditors is estopped from rescinding on grounds of fraud and sharing ratably with (or advancing priority over) other general creditors, where a national securities exchange, acting in

accordance with the regulatory plan of the Securities Exchange Act of 1934, has relied upon the validity of the subordination agreement in approving the subordinated loan as good capital for purposes of the net capital rule and other financial responsibility requirements?

2. Whether a subordinated investor in a broker-dealer is estopped from rescinding without proof of actual reliance by general creditors where the lender has expressly provided in his agreement that a premature withdrawal of capital could be made only with the consent of a national securities exchange and such consent was never requested nor obtained?

STATEMENT OF THE CASE

Effective May 24, 1973, the stock brokerage firm of Weis Securities, Inc. ("Weis") was placed in liquidation pursuant to the provisions of the Securities Investor Protection Act of 1970, 15 U.S.C. §§ 78aaa, *et seq.* (the "Protection Act"). Claims were filed by 52 subordinated lenders of Weis. By application dated April 23, 1974, the Trustee proposed that the claims of the subordinated lenders be recognized, but only in accordance with the terms of the agreements. (Record Document No. 26) Twenty-three subordinated lenders (hereinafter "claimants") filed objections to the Trustee's position, asserting that they were entitled to rescind their agreements on grounds of fraud and to share ratably with, or in priority to, Weis' other general creditors.

On December 12, 1974, the Trustee moved for summary judgment on the grounds that claimants' subordination agreements were, as a matter of law, enforceable with respect to Weis' general creditors, even if procured by fraud. (A260-A305)* None of the material facts were disputed.

* "A" refers to Joint Appendix for Claimants.

On July 16, Bankruptcy Judge Babbitt denied the Trustee's motion. In his memorandum opinion, Judge Babbitt concluded that an evidentiary hearing was required to establish (1) whether Weis' general creditors actually relied upon claimants' subordination agreements or the net capital rule, and (2) whether claimants' agreements contain promises directly to the Exchange.

The Trustee and the Securities Investor Protection Corporation ("SIPC") appealed to the District Court from the Bankruptcy Court's decision. (Record Document Nos. 84 and 85) On January 20, 1977, District Judge Wyatt filed an opinion and order reversing the order of the Bankruptcy Court and remanding the matter to the Bankruptcy Judge for further proceedings consistent with Judge Wyatt's opinion. (425 F.Supp 212; A406-A423) In his opinion, Judge Wyatt held that "between the customer and other general creditors of Weis on the one hand (for whom the trustee speaks), and the subordinated lenders on the other, the agreements of the latter should be enforced according to their terms in distributing the assets of Weis." (425 F.Supp. 216, A418) In addition, the District Court held that if the subordinated lenders proved fraud, their claims should be paid before any distribution to the stockholders of Weis. In so holding, Judge Wyatt recognized that every customer and general creditor of Weis was entitled to rely upon enforcement of the Exchange Act provisions by the regulatory organizations designated by Congress. The undisputed facts in this case show that New York Stock Exchange, Inc. (the "Exchange"), in carrying out its statutory duties with respect to Weis, relied upon the capital contributed by claimants under their subordination agreements. In addition, claimants' agreements and the net capital rule of the Exchange, to which they expressly agreed to be bound, provided that capital could not be withdrawn prior to the maturity date without the prior written approval of the Exchange. Such approval

was never requested nor obtained. On the basis of these facts, Judge Wyatt concluded that there need not be proof of actual reliance on the subordination agreements by Weis' customers or general creditors in order that the subordination agreements be treated as enforceable with respect to Weis' customers and general creditors.

STATEMENT OF THE FACTS

The material facts are not disputed and are set forth in the District Court's opinion (425 F.Supp. 213-215), the affidavits of James W. Giddens, Esq., attorney for Edward S. Redington, Trustee for the liquidation of Weis (the "Trustee") (A267-A278), Janet Belsky, a senior vice president in charge of operations of Weis (A279-A294), Harvey J. Bazaar, a certified public accountant with the firm of Coopers & Lybrand (A295-A302), and Robert M. Bishop, a senior vice president of the Exchange (A303-A305).

Weis was, until May 24, 1973, a member organization of the Exchange engaged in the general business of a broker-dealer. Under section 15(c)(3) of the Exchange Act, a broker-dealer which is a member of a national securities exchange is prohibited from transacting business unless it complies with minimum net capital requirements as the Securities and Exchange Commission (the "Commission") "shall prescribe as necessary or appropriate in the public interest or for the protection of investors to provide safeguards with respect to the financial responsibility of brokers and dealers . . ." 15 U.S.C. § 78o(c)(3). Pursuant to this authority, the Commission required that broker-dealers who were members in good standing of the Exchange comply with the Exchange's net capital rule. The Exchange's rule was "deemed by the Commission to impose requirements more comprehensive than the requirements" of the Commission's rule. 17 C.F.R. § 240.15c3-1(b)(2).

The Exchange's Net Capital Rule

Rule 325 of the Exchange establishes certain minimum capital requirements that must be satisfied by member organizations of the Exchange, expressed as a percentage of aggregate indebtedness to net capital as defined in the rule. (Bazaar Aff., ¶ 3, A296) This net capital requirement has two purposes. First, it is intended to insure that the Exchange's member organizations have sufficient liquid assets to meet their operating requirements. Second, the net capital rule represents a rough measurement of the capital required by a broker-dealer in relation to the risk of the business, including the risk to customers and other creditors. *Id.*

Under Rule 325 every member organization doing business with the public is required to maintain (1) a minimum dollar amount of net capital; and (2) a ratio of aggregate indebtedness to net capital not in excess of 1500%. 2 CCH *NYSE Guide* ¶ 2325(a) (1972)*. A member organization is required to notify the Exchange forthwith if its net capital does not equal or exceed the minimum required by the Rule or if the ratio of aggregate indebtedness to net capital exceeds 1200%. *Id.* In calculating its net capital, an Exchange member organization may include cash or securities covered by subordinated loans provided the borrowing is made pursuant to a form of agreement that is approved by the Exchange. 2 CCH *NYSE Guide* ¶ 2325(b)(2) (1972). Further, the borrowing member organization is required to file an application with the Exchange together with an application signed by the lender, and the proposed lender must be approved by the Exchange. 2 CCH *NYSE Guide* ¶ 2325.20 (1971).

* The Exchange rules referred to in this brief were those in effect during the events covered by this lawsuit. The regulatory scheme of the Exchange has remained essentially the same since that time and any changes in those rules have no bearing on the issues in this litigation.

In addition to the requirements of Rule 325, in July 1971 the Exchange adopted Rule 326 which is intended to prevent possible net capital violations from occurring by requiring preventive steps to be taken in advance of a possible violation and by alerting the Exchange and other regulatory agencies to a potential problem. Specifically, Rule 326 prohibits a member organization from expanding its business under the conditions provided in that Rule and requires a member organization to reduce its business under other conditions provided in the Rule. 2 CCH *NYSE Guide* ¶ 2326 (1971).

Claimants' Subordination Agreements

In accordance with the constitution and rules of the Exchange, each of the claimants applied to the Exchange for approval as a subordinated lender to Weis. Each application stated that claimant agreed to abide by the constitution and rules of the Exchange as in effect from time to time, and copies of claimants' subordination agreements were submitted to the Exchange for review and approval. (Bishop Aff., ¶¶ 3-4, A303-A304)

Upon investigation, the Exchange found each of the claimants to be acceptable as a subordinated lender and the proposed form of subordination agreement to meet the requirements of Rule 325. Accordingly, the Board of Directors of the Exchange approved claimants' applications to be admitted as subordinated lenders of Weis. Weis was so advised and claimants' subordinated loans to Weis were, accordingly, treated as net capital of Weis under Rule 325. *Id.*

The subordination agreement of each claimant contained the following provisions, in substantially similar language: (1) in the event of insolvency, bankruptcy or liquidation, claimant is not entitled to share in the distribution of the assets of Weis until the claims of all creditors of Weis have been satisfied or provision made therefor; (2) if the claim-

ant's property is sold or otherwise disposed of, claimant shall have only a subordinated contract claim against Weis; (3) until the maturity date, claimant shall not withdraw his property or be repaid without the prior written consent of Weis and the Exchange; and (4) if withdrawal is made when Weis is insolvent, claimant shall repay and return to Weis either the property withdrawn or property of equal value. (Giddens Aff. ¶ 4, A268-A269)

Each claimant received interest on the value of his subordinated loan to Weis in the amount set forth in Exhibit A to the Giddens affidavit. (A273-A278) In addition, claimants who contributed securities to Weis were permitted under their respective subordination agreements to retain all rights of ownership, including the right to dividends and interest on such securities.

Weis' Financial Statements

An audited financial statement as of May 26, 1972 was prepared by the accounting firm of Touche Ross & Co. in accordance with the provisions of the Exchange Act and the rules promulgated thereunder and the rules of the Exchange. (Belsky Aff., ¶ 3, A279-A280); NYSE Rule 418, 2 CCH NYSE Guide ¶ 2418 (1967); SEC Rule 17a-5, 17 C.F.R. 240.17a-5. The audited financial statement disclosed Weis' excess net capital as of that date and the amount of liabilities subordinated to the claims of Weis' general creditors. (Ex. A to Belsky Aff., A281) In addition, unaudited statements of financial condition were prepared by Weis as of November 24, 1972 and February 23, 1973. Those statements disclosed the amount of Weis' excess net capital and the amount of liabilities subordinated to the claims of general creditors. (Exs. B and C to Belsky Aff., A293-A294) Copies of Weis' audited and unaudited financial statements were mailed or distributed to customers and creditors of Weis and to other members of the public. (Belsky Aff., ¶ 4, A280)

Interest of the Exchange in this Proceeding

Under Section 6 of the Exchange Act, the Exchange is charged with, among other things, enforcing compliance with its rules "to protect investors". The cornerstone of the Exchange's rules and regulations designed to maintain such financial responsibility by member organizations of the Exchange is Rule 325, the net capital rule, under which capital made available pursuant to a satisfactory subordination agreement plays a vital part.

In 1970, subordinated borrowings by 324 member organizations of the Exchange carrying accounts of public customers amounted to \$1.1 billion out of total capital of \$2.9 billion. SEC, *Study of Unsafe and Unsound Practices of Brokers and Dealers*, p. 78 (1971). For more than a third of the Exchange's member organizations, subordinated loans and accounts constitute 20% or more of total capital. *Id.* at 66-67.

The consequence of permitting claimants to rescind would be to eliminate subordination agreements as a source of capital for the brokerage industry and thereby jeopardize the financial stability of stock brokerage firms.

ARGUMENT

Reliance on Claimants' Subordination Agreements by Weis' General Creditors Must Be Presumed as a Result of the Pervasive Regulatory Scheme Governing the Financial Responsibility of Broker-Dealers.

It is not disputed that a valid subordination agreement is enforceable according to its terms in bankruptcy, and that principles of estoppel would bar rescission of a subordination agreement where there has been reliance upon the agreement. *See In re Credit Industrial Corporation*, 366 F.2d 402 (2d Cir. 1966). The question is whether the

requirement of reliance is satisfied in this case by the regulatory scheme governing the financial responsibility of broker-dealers such as Weis.

A. The regulatory scheme of the Exchange Act

Federal regulation of the securities industry is based upon a combination of direct governmental supervision and industry self-regulation. The Exchange Act gives the Commission certain supervisory and rule-making powers over broker-dealers, including members of a national securities exchange. Section 15(c)(3), for example, was amended in 1970 to require broker-dealers who were members of national securities exchanges to comply with the Commission's financial responsibility rules. Pursuant to section 17 of the Exchange Act, the Commission also requires broker-dealers to keep a detailed set of specified books and records and to file a certified annual report of financial condition on a form prescribed by the Commission and conforming to certain prescribed standards. Violations of the Commission's rules may result in revocation of registration and loss of the right to transact interstate business. Exchange Act § 15(a)-(b), 15 U.S.C. § 780(a)-(b).

In the case of broker-dealers which are members of a national securities exchange, the Exchange Act contemplates that the rules and enforcement procedures of the exchanges will be substituted, in many respects, for those of the Commission. It is only where the exchanges fail "adequately to provide protection to investors that the Commission is authorized to step in and compel them to do so." *Silver v. New York Stock Exchange*, 373 U.S. 341, 352 (1963), quoting the Senate Committee Report on the Exchange Act. As this Court noted in *Gordon v. New York Stock Exchange, Inc.*, 498 F.2d 1303, 1306 (2d Cir. 1974), *aff'd*, 422 U.S. 659 (1975):

That Congress intended Commission-supervised exchange self-regulation to be of central importance in

the scheme of the 1934 Act is emphasized by the legislative history of the Act. Both House and Senate reports stress the broad responsibility left with the exchanges to administer their own affairs.

To implement these principles, Congress provided in section 6 of the Exchange Act, 15 U.S.C. § 78f (1970)*, for the registration of securities exchanges with the Commission. Section 6(a) required a registration statement to be filed by the exchange which contains an "agreement . . . to comply, and to enforce so far as is within its powers, compliance by its members, with the provisions of" the Exchange Act and the rules and regulations thereunder, and also an "agreement to furnish to the Commission copies of any amendments to the rules of the exchange forthwith upon their adoption."

Congress provided through section 19(a) of the Exchange Act, 15 U.S.C. § 78s(a) (1970), that the Commission be vested with jurisdiction to enforce compliance by registered exchanges with their self-regulatory responsibilities. Section 19(a)(1) authorized the Commission to discipline an exchange for violating the Exchange Act or any rules thereunder, or for failing "to enforce, so far as is within its power, compliance therewith by a member** or by an issuer of a security registered thereon." Pursuant to section 19(a)(3), the Commission could discipline members and officers of registered exchanges. The Commission has, pursuant to section 19(a)(1), withdrawn the registration of a national securities exchange for failure to enforce compliance with the Exchange Act and the exchange's rules. See *San Francisco Mining Exchange v. Securities and Exchange Commission*, 378 F.2d 162 (9th Cir. 1967).

* Exchange Act citations are to the Act as it existed prior to the Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975). The essential regulatory scheme remains the same today.

**Under Section 3(a)(3) of the Act, 15 U.S.C. § 78c(a)(3), the term "member" includes a member organization such as Weis.

In section 19(b) of the Exchange Act, Congress delegated to the Commission jurisdiction to supervise the nature and structure of exchanges. 15 U.S.C. § 78s(b) (1970). One of the matters specifically enumerated was "safeguards in respect of the financial responsibility of members and adequate provision against the evasion of financial responsibility. . . ." 15 U.S.C. § 78s(b) (1970).

Enactment of the Protection Act in 1970 supplemented the federal regulation of the securities industry as provided in the Exchange Act. It increased the role of direct government supervision and specified certain functions to be performed by self-regulatory organizations such as the Exchange. *See generally* 15 U.S.C. § 78iii(c)-(f).

The Exchange's net capital rule and the procedures described in the statement of facts for ensuring compliance with the rule were promulgated and carried out pursuant to the regulatory scheme of the Exchange Act. The Commission specifically excluded members of the Exchange from the Commission's net capital rule, although section 15(c)(3) of the Exchange Act empowered the Commission to adopt a net capital rule applicable to all broker-dealers. The Exchange's rule was found by the Commission to impose more comprehensive requirements than the Commission's own rule. 17 C.F.R. § 240.15c3-1(b)(2).

B. The Exchange approved claimants' subordination agreements and Weis was required to report its compliance with the net capital rule

There is no dispute in this case as to the procedures followed by the Exchange to review claimants' applications for approval as subordinated lenders and their subordination agreements with Weis. Nor are the facts disputed relating to the Exchange's rules and practices to ensure compliance with its net capital rule by its members, including Weis.

The Exchange reviewed the application of each claimant for approval as a subordinated lender of Weis. For subordinated accounts to be included as capital under Rule 325,

the subordination agreement is required to contain certain provisions, including a provision subordinating the loan to the claims of general creditors. The proposed agreement of each claimant was reviewed by the Exchange and found to contain the necessary language. Weis, therefore, could, and did, treat the loans as good capital under Rule 325.

Under the rules of the Exchange, Weis was required to file monthly a report of its financial and operational condition, including compliance with Rules 325 and 326. NYSE Rule 416, 2 CCH *NYSE Guide* ¶ 2416 (1972). An annual audit was required to be conducted of Weis by an independent public accountant. NYSE Rules 417 and 418, 2 CCH *NYSE Guide* ¶¶ 2417-2418 (1967). The audit was required, among other things, to verify the computation of net capital and the procedures followed in computing net capital. 2 CCH *NYSE Guide* ¶ 2417.10(8) (1967). Under Rule 325, Weis was also required to "forthwith notify" the Exchange if its net capital fell below the minimum dollar amount required or if its net capital ratio was below 1200%. In addition, Rule 326 imposed specific restrictions on business expansion or required a business reduction if the conditions imposed by the rule were not met. In short, the Exchange's rules and practices called for and were exercised in this case to ensure compliance by Weis with the Exchange's net capital rule.

C. Weis' customers and general creditors were entitled to rely upon enforcement by the Exchange of Weis' compliance with the net capital rule

It is well established that section 6 of the Exchange Act imposes a duty upon an exchange to enforce the rules adopted pursuant to section 6 and that a private right of action on behalf of public customers will lie to seek damages for injuries suffered as a result of an exchange's violation of that duty. *Arneill v. Ramsey*, 550 F.2d 774 (2d Cir. 1977); *Leak v. New York Stock Exchange*, 548

F.2d 61 (2d Cir. 1977). The essential elements of a section 6 action are: (1) knowledge or reason for the Exchange to know that one of its members is acting in violation of an Exchange rule; (2) failure by the Exchange thereafter to take action; and (3) injury to plaintiff arising from the Exchange's failure to act. *Schonholtz v. American Stock Exchange, Inc.*, 376 F.Supp. 1089 (S.D.N.Y.), *aff'd*, 505 F.2d 699 (2d Cir. 1974); *Marbury Management, Inc. v. Kohn*, 373 F.Supp. 140, 142-43 (S.D.N.Y. 1974); *Steinberg v. Merrill Lynch, Pierce, Fenner & Smith, Inc.* [1973-74 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,599 at 96,122 (S.D.N.Y. 1974).

Although the Exchange has considerable discretion as to the exercise of its section 6 duties, *see, e.g., Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935 (5th Cir. 1971), *cert. denied*, 409 U.S. 842 (1972); *J. R. Williston & Beane, Inc. v. Haack*, 387 F.Supp. 173 (S.D.N.Y. 1974); *Aronson v. McCormick*, 13 Misc.2d 1077, 178 N.Y.S.2d 957 (Sup.Ct.N.Y.Co.), *aff'd*, 6 A.D.2d 999, 177 N.Y.S.2d 1004 (1st Dep't 1958), enforcement of the net capital rule has been regarded by the Exchange, the courts and the Commission as of paramount importance to the protection of investors.

In the *J. R. Williston & Beane* case, *supra*, Judge Connor discussed in some detail the significance of the net capital rule:

In response to a series of questions posed by the Securities Industry Study of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, to the SEC, the Securities Investor Protection Corp., and the NYSE, it was stated:

"Violation of the [net capital] rule has always been regarded as meaning that there is an immediate threat to customers of the broker-dealer and to others with whom he deals which must be imme-

diately rectified. The threats posed by continued violation of the net capital rule can be analogized to the prospective danger of a bank insolvency."

In *Securities and Exchange Commission v. General Securities Co.*, 216 F.Supp. 350, 351 (S.D.N.Y. 1963), the Court stated:

"The net capital rule is one of the important protections for the investing public and its enforcement, of course, should never depend on whether actual loss has in fact already occurred. *The chief value of the rule lies in the prevention of loss to the public* (emphasis added).

See *Blaise D'Antoni & Associates, Inc. v. Securities Exchange Commission*, 289 F.2d 276, 277 (5th Cir. 1961). Furthermore, the 1963 Special Study of the Securities Markets found that the NYSE regarded its net capital rule as being of fundamental importance in assuring member financial responsibility. In fact, the record established by the NYSE up to the end of 1963 caused the SEC to find the NYSE's net capital enforcement program to be a model of self-regulation.

* * *

The SEC has stated that,

"a broker-dealer who is not in compliance with net capital requirements must be prevented, as promptly as possible, from conducting any further business, and placing any more investors in financial jeopardy, until its net capital deficiency has been remedied."

Even the Antitrust Division of the Justice Department, which is, as a general proposition, opposed to antitrust immunity for the exchanges, publicly stated that disciplining a member for violation of net capital rules cannot subject an exchange to antitrust liability "if its disciplinary proceedings were fair and its decision

based upon sufficient evidence received in its proceeding.”

387 F.Supp. at 179-80.

It would indeed be anomalous to conclude that a public customer, without proof of reliance, could sue the Exchange for breach of a statutory duty for failing to enforce compliance with the Exchange's net capital rule, but that even when the Exchange relied upon the validity of claimants' subordination agreements, as the Exchange did here, proof of actual reliance upon such agreements by Weis' general creditors should nevertheless be required to make the agreements enforceable in bankruptcy. As shown by decisions involving regulatory schemes comparable to the federal securities laws, reliance by the regulatory agency is sufficient for purposes of promissory estoppel; proof of actual reliance by general creditors is not required. *See, e.g., Scott v. DeWeese*, 181 U.S. 202 (1901); *Ryan v. Mt. Vernon Nat'l Bank*, 224 F. 429 (2d Cir. 1915); *Ashton v. Glaze*, 95 F.2d 427 (9th Cir. 1938).

In their joint brief, claimants try to belittle the fact that they made their loans to allow Weis to comply with the Exchange's net capital rule knowing that customers and other general creditors of Weis would rely on the existence of such loans. (Br.* 27) Claimants contend that “it is doubtful whether most of Weis' customers and creditors even knew of the existence of the net capital rule.” (Br. 28) Such an argument, however, overlooks the undisputed fact in this case that the Exchange, in carrying out its statutory duties with respect to Weis, relied upon the capital contributed by claimants under their subordination agreements and that, as the District Court correctly pointed out:

. . . Weis and the subordinated lenders knew that the subordination was to meet the statutory requirements

* “Br.” refers to Joint Brief for Claimants.

for a broker-dealer to continue in business and knew that it was for the protection of the general class of Weis' customers who as long as Weis continued to operate, were becoming general creditors of Weis. (425 F.Supp. at 216; A418).

The claimants themselves argue that if Weis' creditors "relied upon anything at all, they relied upon . . . adequate supervision of Weis by the SEC and by the NYSE" (Br. 10) It is precisely because the customers and other general creditors of Weis relied upon the supervision of the Exchange in the application of its net capital rule and because the Exchange, in applying its net capital rule, accepted and relied upon the claimants' subordinated loans as a basis for compliance that Judge Wyatt was able to conclude that under the circumstances actual reliance on the agreements themselves is not required to be shown. (425 F.Supp. at 217; A419)

In sum, claimants should not be heard to complain that they are being compelled to comply with the provisions of their subordination agreements because the actual reliance shown is that of the Exchange acting pursuant to the provisions of the Exchange Act rather than that of Weis' general creditors.

D. The Claimants' Reasoning is an Insufficient Basis for Requiring Actual Reliance

The reasons given by claimants for requiring proof of actual reliance by Weis' general creditors are plainly inadequate. First, it is irrelevant to the question of reliance whether the net capital rule was for the purpose of requiring broker-dealer liquidity against current customer demands. (Br. 10, 23-24) Whatever the purpose of the rule, a broker-dealer may be suspended for failure to comply with the net capital requirements. In such circumstances, Weis' customers would not have maintained accounts with Weis and credit would not have been extended by other general creditors.

By viewing the net capital rule as a purely operational requirement, claimants argue that, since Weis has ceased operating as a broker-dealer, the net capital rule is irrelevant and does not bear upon the distribution of Weis' assets in liquidation. (Br. 24) Claimants have simply misread the Exchange's net capital rule. The rule, by requiring subordination agreements to provide for subordination to the claims of general creditors, is intended to and does provide some protection in the event of insolvency. (Bazaar Aff., ¶ 3, A-296) For claimants to contend that the net capital rule and, in turn, their subordinated loans, only served a function while Weis continued to operate as a broker-dealer totally disregards the very terms of the subordination agreements. As required by the net capital rule, those agreements state that in the event of liquidation, claimants will not be entitled to share in the distribution of the assets of Weis until the claims of all creditors of Weis were satisfied. (Giddens Aff., ¶ 4, A268-269) It is clearly only in the event of insolvency that the provision for subordination would have any impact.

Secondly, it may be that Weis' general creditors relied upon Weis' financial statements rather than the net capital rule in extending credit. (Br. 10, 28) However, those financial statements were prepared and circulated pursuant to Exchange rules. If appellants' subordination agreements did not conform to Exchange rules, appellants' investments in Weis could not have been shown on Weis' financial statements as part of Weis' capital. In short, it should be held that the requirement of reliance is satisfied, without proof of actual reliance by Weis' general creditors, by reason of the self-regulatory scheme and the performance by the Exchange of its regulatory responsibilities.

Finally, claimants argue at some length that to deprive them of their right to rescind fraudulently induced subordination agreements would defeat the purpose of the net capital rule by tending to discourage banks and other lenders from making long-term loans to broker-dealers on

a subordinated basis. (Br. 25-26) Claimants contend that if such subordinated lenders were required to assume "the risk of recovering nothing in case the loan is procured by the broker's fraud and the broker subsequently becomes insolvent", they would avoid making such loans. However, claimants' contention overlooks the overriding concern that if subordinated lenders were allowed to rescind their loans in a case such as the present one, customers and general creditors of broker-dealers would be unable to rely upon a broker-dealer's apparent compliance with the federal regulatory scheme. Without the protection provided by the securities laws and the Exchange rules, customers or other general creditors would be unwilling to deal with broker-dealers and the structure of the securities industry would be impaired. In addition, subordinated lenders are in a far better position and, considering the nature of their investment and its potential yield, have a greater interest in thoroughly investigating and protecting themselves with respect to the broker-dealer with whom they are knowingly subordinating their loans or accounts. There is no such interest or incentive on the part of the ordinary public customer or general creditor, nor should there be since they must rely on the fact that the broker-dealer is an ongoing concern in compliance with the securities laws and the Exchange's rules.

II

By Agreeing to Abide by the Constitution and Rules of the Exchange and Agreeing to Obtain Exchange Approval of Withdrawal of Capital Prior to the Maturity Date of the Agreement, Claimants Have Waived Any Right to Require Proof of Reliance by Weis' General Creditors.

In his opinion, Bankruptcy Judge Babbit held that an evidentiary hearing was required to determine whether "the subordinated lenders [claimants] entered into a separate subordination agreement with the New York Stock Exchange." (A387) In characterizing the Bankruptcy

Court's decision on this issue, claimants merely state that Judge Babbitt found "no evidence that such contracts existed."* (Br. 4) However, both claimants' and Judge Babbitt's statement of the issue is inaccurate. It is not contended that claimants entered into a subordination agreement with the Exchange. What is contended is that claimants specifically agreed at the time that they applied for approval as subordinated lenders of Weis to be bound by the constitution and rules of the Exchange. Further, claimants provided expressly and unambiguously in their subordination agreements that their capital would not be withdrawn prior to the maturity date of the agreement without the prior written approval of the Exchange. (Giddens Aff., ¶ 4, A268-A269) Those facts are not disputed.

Judge Babbitt's conclusion that an evidentiary hearing was required with respect to promissory obligations of claimants running directly to the Exchange was based upon an apparent misreading of *In re Credit Industrial Corporation*, 366 F.2d 402 (2d Cir. 1966). There, as here, subordinated lenders sought to rescind their agreements with the bankrupt on grounds of fraud and argued that proof of reliance by senior creditors was required. This Court, reversing the District Court, held that an evidentiary hearing was not required and that under the unambiguous terms of the subordinated lenders' agreements with the bankrupt any right to require proof of reliance had been waived. This Court merely stated in dictum, which was quoted by Judge Babbitt, that proof of reliance may be necessary in some cases if equity is to be done and where it is shown that the subordination agreement is unlawful. On the facts of the

* Claimants also note that "the District Court did not consider this issue" and that, therefore, it is not presented for review on this appeal. Claimants are incorrect, however, since the District Court did consider the issue in reaching its determination to reverse the Bankruptcy Court. (425 F.Supp. 214, A408). In addition, whether the District Court had considered the issue or not does not prevent this Court from considering it as a basis for affirming the result below.

case before it, however, this Court rejected the District Court's position requiring proof of reliance, stating (pp. 409-410):

[T]he rule [the District Court] enunciated actually is inequitable with respect to senior creditors. Clearly, the noteholders here neither bargained for, nor anticipated, that their express promise to subordinate their claims against [the bankrupt] to those of existing and future institutional creditors would be conditioned upon proof of reliance on that promise by institutional creditors. In fact, the express terms of their agreements are to the contrary, e.g., they agreed to waive reliance.

Similarly here, it would be "inequitable" to require proof of reliance by Weis' general creditors, because claimants expressly conditioned the premature withdrawal of their capital upon approval by the Exchange. Claimants are not entitled now to insist that proof of reliance by Weis' general creditors be required, knowing as they did, that the consent of the Exchange was not obtained and would not have been obtained if Weis' net capital position were thereby impaired.

CONCLUSION

The undisputed facts in this case are that the Exchange, in carrying out its regulatory duties with respect to Weis, relied upon the capital contributed by claimants under their subordination agreements. For this reason, Judge Wyatt's determination that there need not be proof of actual reliance on the subordination agreements by general creditors is correct as a matter of law and should be affirmed. In addition, it is conceded that claimants agreed to be bound by the constitution and rules of the Exchange. Claimants' agreements, and the net capital rule to which they expressly agreed to be bound, also provided that their investments in Weis could not be withdrawn prior to the maturity date

without the prior written approval of the Exchange. Approval was never requested nor obtained. Such circumstances serve as an additional basis for affirming the result below.

June 10, 1977

Respectfully submitted,

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UNITED STATES COURT OF APPEALS
FOR THE SECOND CIRCUIT

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In The Matter Of	:	
WEIS SECURITIES, INC.,	:	
	:	Debtor.
GEORGE D. ALDRICH, et al.,	:	AFFIDAVIT OF SERVICE
	:	OF MOTION FOR LEAVE
Claimants-Appellants.	:	TO FILE BRIEF AMICUS
	:	CURIAE AND AMICUS
v.	:	CURIAE BRIEF
EDWARD S. REDINGTON, Trustee and	:	
SECURITIES INVESTOR PROTECTION	:	
CORPORATION,	:	
	:	Appellees.

- - - - -X

STATE OF NEW YORK)
 : ss.:
COUNTY OF NEW YORK)

MICHAEL BRAUNSBURG, being duly sworn, deposes and says:
I am over the age of eighteen years and am not a party
to this action.

On June 10, 1977, I served the within Motion For Leave
To File Brief Amicus Curiae and Amicus Curiae Brief of the New
York Stock Exchange, Inc., upon the attorneys named below, by
depositing a true copy thereof, securely enclosed in a post-paid
wrapper, addressed to each of such attorneys at his respective
address in a mailbox maintained by the Government of the United
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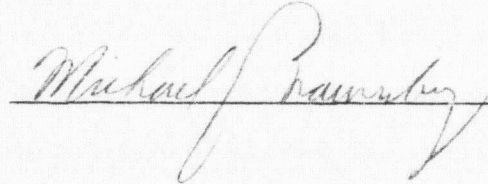
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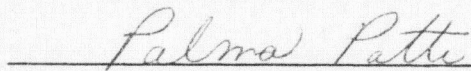
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Sworn to before me this
10th day of June, 1977.



PALMA PATTI
NOTARY PUBLIC, State of New York
No. 60-43-1431
Qualified in Westchester County
Commission Expires March 30, 1979

